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ABSTRACT

This publication identifies a variety of situations in which it may be necessary to use professional judgement in the needs analysis of students requesting financial aid. Alternatives are suggested to aid administrators in more sensitively assessing the ability of a family to pay for postsecondary education. The intent is to describe alternative ways of considering particular circumstances. Specific topics covered include principles of need analysis, student budgets, standard need analysis procedures, adjustments in calculation of financial need, determining necessary adjustments, reviewing need analysis data, evaluating personal data, evaluating parents' information including various sources of income and assets, areas to consider in assessing allowances against parents' income, dependent student issues, independent student issues, and children of divorced or separated parents. Appendices contain: (1) a reprint of the amended version of the Higher Education Amendments (1992); (2) a brief description of common federal tax forms and schedules that can be used in the assessment; and (3) a guide to addressing special circumstances in student financial assistance. (Contains a 21-item bibliography.) (GLR)

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Monograph
A NASFAA SERIES
November 1993, Number 10
Practical Information for Student Aid Professionals

ED 364 171

Professional Judgment in Eligibility Determination And Resource Analysis

This publication identifies a variety of situations in which it may be necessary to use professional judgment in need analysis. Alternatives are suggested to assist aid administrators in assessing more sensitively the ability of a family to pay for postsecondary education. The intent is to describe alternate ways of considering particular circumstances. Not all aid administrators will agree with every adjustment cited. Instead, it is hoped that this publication will provide a foundation on which good practice and consistent treatment of aid applicants can be developed.

For nearly forty years, aid administrators and others have debated the nature and structure of need analysis. As it developed, need analysis was based on commonly accepted definitions and basic principles of economics. Beyond the fundamentals of need analysis, there also developed expertise about exercising professional judgment in reviewing and, if necessary, adjusting the results of need analysis. This expertise about discretionary decisions has been shared formally in organized meetings and informally in day-to-day conversations.

This publication discusses various ways of exercising professional judgment. It is not the intent to be all-inclusive, but to provide financial aid administrators with guidelines or suggested alternatives that may be exercised in determining eligibility for federal financial aid and in analyzing a family's reasonable ability to provide for postsecondary educational expenses.

As used in this monograph, the term "need analysis" includes both eligibility determination and resource analysis. Eligibility determination for federal financial aid is embodied in the Federal Methodology. "Resource analysis," a concept advanced by the NASFAA Need Analysis Standards Committee, represents a reasonable measure of a family's ability to contribute toward postsecondary education costs and may be used by institutions, agencies, and donor organizations in determining eligibility for non-federal financial aid.

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An Introduction to Need Analysis

The purpose of need analysis is to assess a family's financial resources to determine a reasonable amount that can be expected to be provided to help meet the cost of postsecondary education. A uniform set of criteria is used to make this assessment in need analysis. Although the criteria may appropriately be applied to a wide variety of family situations, there are cases in which strict adherence to the criteria may not be appropriate. Deciding whether the standard procedures apply to a given case is left to the discretion of the financial aid administrator in exercising professional judgment.

Need Analysis Principles

In need analysis the aid administrator consistently applies the same objective standards to all applicants. The need analysis system is designed to accommodate obligatory expenses, such as taxes, as well as typical family living costs. In some cases, however, the financial strength of a family cannot be portrayed accurately by using the standard procedures. Because each family's situation is unique, extraordinary circumstances occasionally will arise that require individual attention. In these cases, the aid administrator is expected to weigh the family's situation both objectively and subjectively in order to render a professional judgment about the financial support that the family can reasonably provide toward the applicant's postsecondary expenses. Professional judgment is a key factor in the student financial aid delivery system — the capacity for personal intervention by the aid administrator in cases that merit individual attention.

An understanding of the basic principles of need analysis is essential to the aid administrator's review of any case. Among these tenets are the following:

- For dependent students, both the student and parents share the obligation to contribute toward educational expenses.
- For independent students, it is expected that a major part of the student's income and assets will be allocated to the student's educational costs as well as the family's living expenses.
- Families are considered equitably in relation to one another—that is, there is "horizontal equity" among families in similar situations and "vertical equity" among those in dissimilar situations.
- The analysis of a family's situation is an objective assessment of their present circumstances; it does not make assumptions or prejudge the nature of their situation.
- Progressive assessment rates are used to calculate the family contribution so that those with greater resources have a larger proportion of those resources deemed available for educational expenses than those of more modest means.
- Need analysis procedures recognize that part of family resources must be devoted to taxes, basic living costs, and other unavoidable expenses; other expenditures that are a matter of family choice are usually not included as allowances against available income or discretionary net worth.

The latter point is an important element of professional judgment in need analysis. That is, *the aid administrator should be able to distinguish between changes in a family's circumstances that are a function of choice, and those that are a function of necessity.* Using this distinction in expenses will help the aid administrator make better decisions about a given family's circumstances.

Need analysis is not intended to be a rationing device and therefore should not be tailored to available financial aid funding. The end result of need analysis is a measure of a family's wherewithal and a calculation of need for assistance, regardless of whether resources are available to meet the student's full need.

Student Budgets

Determination of a family's ability to pay for educational expenses is but one part of need analysis. Equally significant is the construction of a realistic student expense budget. (See NASFAA Monograph No. 9, *Constructing Student Expense Budgets*, April 1993.)

Some situations may call for an adjustment on the budget side of the need equation instead of on the side of calculating a family contribution. For example, allowances for unusually high transportation costs may appropriately be reflected in an adjustment to the expense budget rather than as a change in the expected family contribution. It should also be recognized that some changes in allowances in need analysis have no effect because of the student's or family's circumstances. In such cases it may be appropriate to adjust the student expense budget — especially to address an independent student's needs — rather than alter the need analysis.

Standard Need Analysis Procedures

Since the establishment of a broadly used scheme of need analysis in the early 1950s, the system has been modified from time to time to provide a systematic approach to measuring family ability to pay for college. Beginning in 1975 the need analysis system most widely used was the Uniform Methodology, which was a product of the National Task Force on Student Aid Problems. Most aspects of the Uniform Methodology were incorporated in the 1986 amendments to the Higher Education Act, Title IV, Part F, also known as the "Congressional Methodology."

The Higher Education Amendments of 1992 brought substantial changes to need analysis. The formulas for determining Pell Grant eligibility and for calculating family contributions for other federal student assistance were combined. The revised formula is usually called the Federal Methodology or FM. In addition, the number of data elements used in the unified federal formula was pared down and, under certain circumstances, consideration of some or even all of the remaining data elements was eliminated. The intent of these revisions was to streamline the application process for many students and their families, and to expand eligibility for federal student assistance.

In restructuring the federal eligibility determination formula, the Congress also recognized that institutions, state programs, and other donors of student assistance may use additional data and different formulas to determine their financial aid awards. In a 1989 position paper, entitled *A Plan for Reform* (*Special Report #31*, February 1989), the NASFAA Need Analysis Standards Committee distinguished between need analysis used to determine eligibility for federal funds and need analysis to determine eligibility for institutional funds. The latter was termed "resource analysis" (RA).

In this monograph discussion of the Federal Methodology is based on the explicit definition and delimited set of data elements in the 1992 revision of the Higher Education Act, Title IV, Part F. As provided in the statute, professional judgment is restricted to the data elements in the formula and other considerations outlined in the Conference Report to the Higher Education Amendments of 1992 (*Report 102-630*, June 29, 1992). The FM formula is also used to determine eligibility for financial aid programs of the Department of Health and Human Services under Title VII of the Public Health Service Act.

For discussion purposes the RA formula for dependent students is based on the Congressional Methodology embodied in the 1986 Higher Education Amendments, including professional judgment concerning the methodology and resulting contribution figures, as well as the data elements used in the formula. For independent students the RA and FM formulas are basically identical.

Adjustments in Calculation Of Financial Need

Adjustments in need analysis — whether in the student expense budget or the determination of family contribution — may result in either an increase or decrease in the student's need. If the aid administrator is satisfied that the adjustment is based on verifiable information and may be justified as reasonable on grounds of professional judgment, the resulting need figure should be valid for all forms of aid. Nevertheless, for federal student financial aid purposes, the need figure must be within statutory limits that apply to the FM formula.

Effective with the 1993-94 award year, the Federal Methodology formula must be used for determining eligibility for federal student financial aid programs. These procedures are specified in Part F of Title IV of the Higher Education Act, as revised in 1992. The law, however, does not preclude adjustments in need analysis. Indeed, the Higher Education Act provides that discretionary judgments may be employed by aid administrators on a case-by-case basis for students or families with unusual circumstances. (The full text of Section 479A of the Higher Education Act appears in Appendix A.)

In addition, the Conference Report that accompanied the Higher Education Amendments of 1992 noted that

> The conferees intend that financial aid administrator discretion be extended to four areas that were previously included as part of the formal financial aid application [because they were explicitly stated in the 1986 version of Part F]. These include: (1) private elementary and secondary education expenses, (2) dislocated worker status, (3) displaced homemaker status, and (4) unusual medical and dental expenses. The conferees believe these are concerns that should not and must not be disregarded. The conferees also intend that financial aid [administrator's discretion] can be used when base year income is not [an] appropriate estimate of expected year income. The conferees expect financial aid administrators to take positive action for students and families whenever the need is warranted in any and all of these areas.

In developing the Free Application for Federal Student Aid, the Department of Education recognized the

role of professional judgment by noting in the form that aid applicants should contact their financial aid administrator in situations cited in the preceding paragraph as well as in other situations in which "unusual circumstances not covered in this form ... would affect [their] eligibility for student financial aid."

Determining Necessary Adjustments

Basis for Changes

An examination of the student's application materials is usually the first step in deciding whether the calculated family contribution is appropriate to the student's situation. In many cases this review will not reveal any reason for an adjustment to be made or additional information or clarification to be sought. If this is the case, the aid administrator may proceed with construction of the student expense budget, calculation of need, and packaging of financial aid. In other cases, however, it may be necessary to obtain information in addition to that found on the application, need analysis documents, or other materials already submitted by the student.

Documentation

If the aid administrator determines that the need analysis should be changed, the reasons for the revision should be sufficiently documented in the student's record so that any aid awarded as a result of the change can be explained in an audit or program review. The documentation will also provide a history of the applicant's circumstances as a reference for the future. It may be helpful to compile a record of exceptions so that institutional policies regarding professional judgment may be developed as the basis for consistent treatment of other aid applicants with similar circumstances. There are no standard guidelines for documentation; however, sufficient notes should be made so that another aid administrator reviewing the student's case could easily ascertain the reason any changes were made as well as their effect on the need analysis and aid package. The source of information, name of the aid administrator making the adjustment, and date should also be recorded.

Distinction from Verification

Making a professional judgment sometimes involves the collection and interpretation of additional information from the family. In this sense, professional judgment should not be confused with efforts to verify information provided by the family, although in some instances it may be difficult to separate these issues, particularly if the information from a Verification Form suggests a need for follow-up in related or additional areas.

Tools Used in Review

The aid administrator has available a number of tools that can help in reviewing a student's file. These may include the Student Aid Report (in paper or electronic form), need analysis forms and reports, an institutional application, income tax returns, and other documents obtained from the student and his or her family to substantiate the information on which the need analysis is based. The Student Aid Report contains the basic data used to calculate the family contribution and determine financial need. Supplemental information collected through other documents may also assist in determining need. The nature and consistency of the information reported by the family may indicate whether an adjustment is needed or additional information should be requested.

Student Aid Report (SAR). The SAR reproduces the data the student and his or her family recorded on the Free Application for Federal Student Aid (FAFSA). The messages resulting from federal edit procedures, listing of assumptions made, and other comments recorded on the SAR indicate areas about which further information or clarification should be sought.

Need analysis documents. A national need analysis service may prepare reports that provide the details of the FM formula as well as institutional need analysis. The reports may also contain messages to assist the aid administrator in interpreting the information reported by the family. Other messages may relate to the verification or other regulatory requirements of the United States Department of Education. Some messages may note assumptions made by the national service in developing the need analysis or highlight items that may need review by the aid administrator because of apparent inconsistencies. By referring to these messages the aid administrator may decide to follow up on relevant data elements in the need analysis documents and, if necessary, make adjustments in the analysis.

Institutional aid applications. Relevant additional information may be recorded on an institutional application form. This may include biographical and financial data and information about the family situation. There may be unusual circumstances that affect the family's ability to meet college expenses. Such information may assist the aid administrator in reviewing the need analysis and in making adjustments to the assessment of a family's ability to pay.

Income tax returns. Institutions may require that their aid applicants submit copies of income tax returns to substantiate the information reported in the SAR and need analysis documents. The instructions for the FAFSA and the standard need analysis forms published by the national services contain numerous references to the individual income tax return (IRS Form 1040, 1040A, or 1040EZ) and to supplementary schedules that may be submitted with Form 1040 (for example, Schedule A for itemized deductions, and Schedule B for interest and dividend income). Income tax returns reveal certain kinds of untaxed income, such as interest from tax-exempt bonds, untaxed portions of pensions and social security benefits, and earned income credits. Situations affecting family ability-to-pay also may be seen in income tax returns, such as unusual medical and dental expenses, child care costs, and unreimbursed employee business expenses. Income tax returns may be especially useful in interpreting more complex family situations, especially when income is derived from sources other than wages or salaries from employment. Wages statements (W-2 forms) are also useful in documenting income — especially for earnings of non-tax filers and tax-deferred income. In instances of students from families that own a substantial part of a corporation or partnership, some aid administrators also ask that copies of corporate or partnership tax returns be submitted for review. Appendix B includes a summary of common federal income tax return forms and schedules, and Appendix C contains a "Guide to Implied Assets and Income." (NASFAA annually publishes in the *Newsletter* updated, year-specific versions of these appendixes as well as a summary of relevant income tax form references.)

Other documentation. It is important to recognize that income tax returns do have limitations in the review process. Tax returns do not enable the aid administrator to check all the items that are taken into account in ability to pay. In some instances, the aid administrator may want to obtain additional documentation from the family or certified statements from third parties to substantiate other data appearing in the SAR and other need analysis materials. These data might include:

- Untaxed income and benefits — social security and other retirement and survivors' benefits, veterans' benefits, welfare payments, housing and subsistence allowances, gifts, inheritances, bequests, and so forth.
- Asset holdings — value of home and other real estate, outstanding mortgage balances, cash, savings, and checking accounts, investments, and business and farm assets and indebtedness.
- Parents' or student's marital status, including additional information in divorced or separated situations, such as alimony and child support payments, arrangements for paying college costs, and so forth.
- Number of family members, number in college, and elementary and secondary school costs.

"Guide to Addressing Special Circumstances." In particular reference to situations warranting the exercise of professional judgment, the 1992-93 NASFAA Need Analysis Standards Committee developed a "Guide to Addressing Special Circumstances." The guide was published in the December 18, 1992, *NASFAA Newsletter* and is included in Appendix D of this monograph. The guide is especially useful in identifying ways to collect additional information from families to help decide whether and to what degree adjustments should be made in an individual student's need analysis.

Reviewing Need Analysis Data

Numerous aspects of need analysis may be explored. The following sections describe procedures that some aid administrators use in reviewing the data used in need analysis. ***It must be kept in mind that adjustments for Federal Methodology formula purposes are limited to data elements only.*** Methodological changes and revision of final contribution figures are not permitted for FM purposes, but may be justified for RA purposes in awarding institutional, state, or private funds.

Personal Data

The review of a student's application should begin with an examination of the demographic information.

Dependency. A major question in considering a stu-

dent's financial need is whether the parents' financial information is to be considered in need analysis. Federal guidelines for dependency status have been established by the Higher Education Act and incorporated in the FAFSA. The federal definition was revised by the Higher Education Amendments of 1992. Under the definition, a student is considered independent:

- If he or she:
  - is 24 years of age by December 31 of the award year; or
  - is a veteran of the United States armed forces; or
  - is a graduate or professional student; or
  - is married; or
  - is an orphan or a ward of the court; or
  - has legal dependents other than a spouse.
- Overriding all other considerations is the authority of the aid administrator to determine a student to be independent on the basis of documentation of other unusual circumstances.

  (The aid administrator does not have the authority to determine a student to be dependent for federal purposes if the student otherwise qualifies as an independent student.)

Obviously the student's responses to the questions establishing dependency status for federal programs may suggest the need to request further documentation from either the student or the parents.

In addition, for financial aid programs under the Public Health Service Act it may be necessary to take into account parental resources in awarding Title VII funds.

In awarding non-federal aid an institution may establish a different definition for determining independence, although care should be taken to treat students within a given category consistently. If the institution's requirements for independent status are more restrictive, the aid administrator may want to collect additional information from the student and his or her parents, such as parental affidavits, rent receipts, and tax forms. Among the factors the aid administrator might consider in making a determination about an applicant's independence are:

- The answers to the standard questions regarding student status;
- The student's address as compared to that of the parents;
- A statement from the parents certifying the student's independence;
- The level of financial support from the parents which the student may report;
- Any knowledge the aid administrator has of the relationship between the student and parents;
- The possibility of others providing support (e.g., grandparents, other relatives, or "alternative parents") especially if the applicant's income in the recent past is such as to make self-support questionable;
- The material presented by the student in support of the application to be considered independent; and
- The student's place of residence in preceding years.

If there are questions about a student's dependency status, it is appropriate to require documentation, including appropriate tax returns from both the parents and the student, notarized statements, and rent receipts or other supporting evidence of a separate domicile.

Economic straits may cause some otherwise independent students to reside temporarily with their parents. Recently divorced or separated persons, individuals leaving military service, or persons who have recently become unemployed may fall in the group. In such cases, the aid administrator may want to review prior dependency status to determine if the living arrangements are in fact temporary and, if so, exercise professional judgment in the treatment of these students.

See Appendix D, Dependency Status.

Other demographic data. The student's responses to other questions that collect demographic information should also be reviewed. Here is a summary of these data and the areas of need analysis that may be affected.

Student's year in college. If the year is incorrect it may be necessary to revise the student's contribution figure, if a minimum value for student self-help is used for institutional purposes to calculate the total family contribution.

Student's marital status. If the status is inaccurate, it may be necessary to recalculate the family contribution. For example, if the student is married, an employment allowance should be included based on the spouse's income. In addition, for independent students, the asset protection allowance differs according to marital status.

Student's number of family members. If the number is incorrect, it is necessary to recalculate the family contribution. For example, for independent students, the income protection allowance, asset pro-

tection allowance and asset conversion rate, all may vary according to whether the student has dependents other than a spouse. Also, the student expense budget, although generally constructed for the student's expenses only, may include an allowance for child care costs or an allowance for unmet basic family expenses (i.e., the amount by which available income may fall short of the income protection allowance).

Student's family members in college. If the number is incorrect, a recalculation of family contribution is necessary. For example, for married students without dependents (other than a spouse), the income protection allowance varies according to whether the student's spouse is also a student. Also, the expected family contribution is divided among family members in college.

Expectation of family support for the student. In some cases such as disinheritance, parents' refusal to file any information, or other unique circumstances, the student may not meet the usual requirements for independence, but may have no parents' contribution on which to rely. The aid administrator may treat such students as independent if institutional policy permits and judicious review merits such consideration.

Parents' Information

Parents' marital status and family size. In most cases the data about parents' marital status and family size are straightforward and there is no ambiguity. In situations in which questions arise, however, it may be necessary to correspond with the student or parents to resolve the matter. If the parents' marital status must be revised, a different asset protection allowance will be used in need analysis. Likewise, if the family size is altered, there will be a change in the income protection allowance.

Exemptions. The number of exemptions claimed on the income tax return is one source for checking the family size. This number will not always agree with family size even if the family size is correct. In divorced or separated cases the noncustodial parent may claim some or all of the children because child support is provided or because the divorce decree or separation agreement specifies such an arrangement. There may also be differences because of a birth, adoption, death, or the departure of someone from the household.

Inclusion of siblings. Some aid administrators will not count siblings who are reported as members of the household unless there is some explanation from the family to justify their inclusion. Among considerations of dependence are whether a sibling is claimed by the parents for income tax purposes and whether he or she is beyond secondary school age but is not in postsecondary education. Older siblings may be included if they are handicapped or mentally retarded and require family financial support. In some cases they may be included if they are unemployed and unable to find work. On the other hand, siblings are usually excluded if they are fully employed and represent no drain on the family's resources. When aid administrators exercise professional judgment with respect to inclusion of older siblings, documentation should always be obtained.

Support for other family members. Documentation should be obtained when adjustments are made to allow for support of grandparents or other relatives. Such support may include nursing home fees, other medical expenses, or general living costs. Although families frequently neglect to detail these expenses in financial aid application materials, the aid administrator should be sensitive to the possibility of there being such expenses that may affect the family's discretionary income.

See Appendix D, Support of Extended Family.

Parents' family members in college. Under the need analysis provisions of the Higher Education Act, all family members who will prospectively be enrolled at least half-time in postsecondary education and working toward a degree or certificate in an eligible program are included in the number in college figure. Should a parent of a dependent student be enrolled, he or she is included in the number in college used to calculate the expected family contribution. For institutional purposes, the financial aid administrator may instead elect to exclude parents from the count of family members in college but recognize their educational costs, especially if the education is expected or required for advancement in employment, retraining, or in other similar circumstances. Expenses to be considered include tuition, fees, books and supplies as well as commuting and food costs. In this case it is reasonable to allow unreimbursed direct educational expenses of a parent as an allowance against parents' available income. Otherwise, if the parent is counted in the number of family members in college, it may be appropriate to subtract the parent's educational expenses from the total parents' contribution and divide the remainder among the dependent children who are in college.

Aid administrators may want to confirm the reported number of family members who will be enrolled at least half-time in postsecondary education and the programs in which they are enrolled. Some institutions have the

practice of asking students to have the other family members verify their status after the academic year has begun by obtaining a certification of enrollment from the other family members' institutions.

For institutional purposes, it may be useful to examine the attendance costs and financial aid of these family members, as well. If their expenses do not represent a substantial drain on family resources, other family members may be excluded from consideration, at the discretion of the aid administrator. For example, family members may attend military service academies or be receiving grants or scholarships that cover their entire educational expenses. Special care may be needed in reviewing applications of enrolled single parents who have dependent children also enrolled in college to ensure that reasonable costs are considered while not overlooking aid the dependent child may receive.

Parents' Income

Definition of Income

The definition of income for need analysis purposes is of prime importance to a fair and rational measure of ability to pay for postsecondary education. In general, need analysis procedures follow the definitions of the Internal Revenue Service. A clear advantage to this approach is the close correspondence between the definition used in need analysis and that used for tax purposes. The data can be obtained by families from their tax returns and, similarly, can be verified by the aid administrator using the same returns. Adjusted gross income, an IRS concept, is the point of departure for determining family income. There are some limitations, however, to the usefulness of adjusted gross income (AGI). The definition of AGI has been developed in order to administer the federal income tax code. This purpose is different from the aid administrator's goal in performing need analysis. Because of this, certain "adjustments to income" allowed for income tax purposes are not allowed for need analysis purposes.

Aid administrators should keep in mind that, especially for institutional RA purposes, income data are used to predict resources available for the academic year in question. It may be helpful to think of income in terms of annual income flow. This concept takes account of additional sources of family support that may be excluded from AGI because of current tax laws. By considering income in this way, the aid administrator may get a clearer picture of a family's financial circumstances — particularly its discretionary income — from year to year without the distortions that are inherent with the tax-related definition of adjusted gross income. Such an income definition might also disregard unusual variations in the pattern of annual income, such as capital gains, and eliminate losses that do not necessarily represent a loss of income. Reasons for disengaging the definition of income from the tax system may be seen when there is a major change in the income tax code, as there was with the Tax Reform Act of 1986. The change in definition of adjusted gross income was substantial enough in some cases to alter significantly the calculation of expected family contribution.

Base Year Versus Estimated Year Data

The standard need analysis calculation assesses prior year income rather than income received during the year the student is enrolled. This income, however, may be subject to wide variation from year to year. A change in income may be attributable to unemployment, illness, or retirement. Income in some occupations, such as sales, farming, and small business operations, may fluctuate from year to year. It may be appropriate in these cases to recalculate the family contribution on the basis of projected income for the estimated year. In some instances adjustments may be made in the middle of the academic year when information for the "estimated" year is no longer estimated.

There is an increasing awareness among aid administrators of the necessity of establishing procedures to assess (or reassess) the need of families whose situations are in flux, such as those who are recently widowed, newly divorced or separated, or those who have become displaced from work. The Congress expressly intended that, for federal purposes, such emergent situations be dealt with under professional judgment. Determining whether it is appropriate to base need calculations on the estimated year deserves careful consideration. For RA purposes, if the need analysis is shifted to the estimated year, some aid administrators make adjustments for inflation in the standard maintenance allowance and in the adjusted available income brackets from which the parents' contribution is derived.

Families may have difficulty in furnishing information about their estimated year income, especially if the aid administrator's request for data is too open-ended. A common practice is to request actual earnings and untaxed income to date for the calendar year in question, with an estimated amount for the rest of the year. For independent students, it may be appropriate to shift to a twelve-month period that includes the academic year. Of particular importance are income reductions related to documented job changes or unemployment. Sometimes

families are pessimistic about extra income, such as sales bonuses or overtime work. Aid administrators usually will not make adjustments in advance for loss of such income unless it is documented by the parent's employer. A review of assets, including ownership, may be considered for newly divorced or separated parents.

In a case with highly fluctuating yearly income, a three-year average may be a treatment worth considering, using copies of tax returns to document the average. An even longer term for averaging may be appropriate in exceptional cases. This procedure may also be followed in considering large one-time gains or losses.

Another area of concern may be income reduction that does not constitute a "special circumstance," but is regarded by the family as significant enough to preclude the student's further enrollment. Collecting additional information through communication with the family may help determine, with as much certainty as possible, the appropriateness of calculating the family contribution on data for the estimated year.

See Appendix D, Income Reduction or Nonrecurring Income.

Detail of Total Income

For an accurate assessment of more complex family financial situations, it may be necessary to examine the separate elements of total income. Sometimes families will provide a total income figure that is derived from more than one source. One line of an application may combine both parents' salaries, business or farm income, or rental income. Boarding school teachers, clergy, members of the military, and persons in similar occupations may omit "in kind" remuneration for housing, board, or transportation. The aid administrator may want to request additional information from such individuals and adjust their income to reflect more accurately the family's financial strength.

Wages, salaries, and tips. Knowing the occupation of the parents may help in assessing the appropriateness of income figures. The number of years on a particular job may indicate whether the family has had the opportunity to accumulate assets for education and other purposes.

It may be useful to compare the occupation listed on a financial aid application with that listed on the income tax returns, if they are collected. For instance, if an aid application lists the occupation as "salesperson," while the income tax return indicates "company president," the aid administrator will probably want to investigate the possibility of business ownership and business worth. Conversely, the occupation may suggest deductions which have been inadvertently omitted by the parents.

The parent's occupation may also alert the aid administrator to changes that may be about to occur. For example, if a parent is employed by a company that has financial problems or has recently laid off employees, this information may prompt an inquiry about the parent's ongoing job security. If there is a loss of employment, further documentation would be necessary, but the original information may help confirm the situation that ultimately developed.

Interest and dividend income. Interest and dividend income is directly tied to the family's statement of the value of their cash, savings and checking accounts, stocks, bonds, and other investments. In cases in which sizable investments are indicated without reasonable interest or dividend income shown, the aid administrator may choose to calculate a reasonable yield on the investments and add it to income. The current interest rate on passbook savings will provide a conservative estimate of yield. The imputed value should be compared with interest and dividend income reported on the family's income tax return and adjusted, if necessary. The imputation of reasonable return on an investment is not always appropriate. For example, United States savings bonds, owner-financed mortgages, and installment sale agreements are examples of assets that yield interest income which may not accurately reflect the value of the assets. Interest and dividend income from tax-exempt investments should be included in untaxed income and not adjusted gross income. Tax-exempt interest income is reported, however, on federal income tax returns.

Depreciation. Under the Internal Revenue Code a taxpayer who owns an asset used for income-producing purposes (e.g., rental property, business assets, or farm assets) can recover the cost of the asset over time by claiming depreciation of its value. For this reason depreciation as an operating expense may present particular problems for the aid administrator. Capital expenditures, such as for buildings, motor vehicles, furnishings, equipment, and inventories, are subtracted from income as expenses over an extended period of time. The period for depreciation of assets is generally related to the expected useful life of the asset. The Internal Revenue Service has elaborate rules for determining the period over which these operating costs may be recovered, though in most instances the depreciation rules overstate the rate at which an asset's value declines. This is particularly the case with buildings and other real estate improvements, which in fact may appreciate in value over time.

Some aid administrators eliminate all depreciation as an allowance against business or farm income. This treatment may be too harsh, however, because depreciation is the only way a business or farm owner may recover

the cost of a capital outlay. A different approach is to allow all or at least a significant portion of depreciation as an expense — especially in cases that involve farming, mining, manufacturing, or other activities in which equipment or motor vehicles are necessary and are subject to more frequent replacement.

Net income (or loss) from business or farm. Only limited information about a family's business or farm is included in standard need analysis documents. Any detailed examination of income from a business or farm will require additional information from the family. This may be obtained through need analysis form supplements completed by the family, profit and loss statements, or copies of the relevant income tax returns for the business or farm. Income tax forms may include:

- Form 1040, Schedule C — profit or loss from business (sole proprietorship)
- Form 1040, Schedule E — supplemental income and loss (rents, royalties, pensions, annuities, partnerships, small business corporations, estates, and trusts)
- Form 1040, Schedule F — profit or loss from farming
- Form 1065 — partnership return of income
- Form 1065, Schedule K-1 — partner's share of income, credits, deductions, etc.
- Form 1120 — corporation income tax return
- Form 1120A — corporation short-form income tax return
- Form 1120S — income tax return for an S corporation
- Form 1120S, Schedule K-1 — shareholder's share of income, credits, deductions, etc. (from an S corporation)

Much information that is useful in evaluating a business may be obtained from its income tax returns. For institutional purposes, the aid administrator may want to examine general sources of income for the business in relation to its principal activity, operating expenses, and reported assets. Compensation of officers and the employment of other family members should be reviewed for consistency with the family income used in need analysis. A close examination of the enterprise's year-end cash position is recommended. Sometimes money will be carried over in the business cash account rather than being drawn as salaries or profits. In cases in which significant cash has accrued, the aid administrator may want to treat a portion of the cash as income for computation purposes rather than leaving it as a business asset.

In reviewing the balance sheets or profit and loss statements of a business corporation or partnership, the aid administrator should compare figures for the beginning and ending of the operating year. Significant changes may reflect fluctuations in business activity as well as financial interactions between the business and its owners. Of particular interest for institutional purposes may be changes in assets, such as cash on hand and loans to stockholders, and in liabilities, such as mortgages, loans from stockholders, and retained earnings. For a partnership or closely held corporation, these changes may represent cash flow to (or at least possibly available to) or from the owners.

The operating expenses of a business or farm may also be reviewed. Business deductions for car and truck expenses and for travel and entertainment sometimes raise questions about whether all such expenses should be allowed to reduce income in need analysis. If the business is operated at home, deductions for such expenses as rent on business property, utilities and telephones, and laundry and cleaning may also be questioned. If other family members are employed by the business, the cost of operations (including labor), and deductions for employee benefits programs and pension and profit-sharing plans should also be examined. For farm cases, deductions are generally more specific and more obviously farm-related. Even so, if other family members are employed on the farm, the aid administrator may want to review deductions for labor hired, pension and profit-sharing plans, and employee benefits programs.

If a business or farm is not the major source of income for a family, losses incurred may be legitimate for income tax purposes, but the aid administrator may not always choose to allow them for purposes of determining the expected family contribution toward educational expenses.

Rents, royalties, partnerships, estates, trusts, etc. The net balance of these various kinds of income is included in adjusted gross income and reported on the IRS Form 1040. To examine income in these categories it usually is necessary to obtain a copy of the family's IRS Form 1040, Schedule E. In the past it was not unusual to find a loss resulting from this income. The Tax Reform Act of 1986, however, eliminated losses from passive income from inclusion in adjusted gross income after 1990. Passive income is derived from activities in which the taxpayer is not actively engaged (e.g., rental property managed by others and limited partnerships).

Rents. Gross income from rental property may be

reduced by expenses for operating and maintaining the property. These include taxes, mortgage interest, utilities, repairs, insurance, and so forth. Most aid administrators accept these expenses, although some will disallow travel expenses if the rents are derived from a vacation property, especially if management fees are allowed. Rental income from an owner-occupied multiple-family dwelling may also warrant closer examination of expenses. Some aid administrators question whether expenses for maintenance and repair would be any different if the dwelling were occupied only by the owner's family, and disallow such costs. It should be noted that although interest expenses are included in IRS Schedule E, the principal represented by mortgage payments on rental property is not included. The aid administrator may want to obtain the amount of this expense from the family so that the net rental income can be properly adjusted. Depreciation on rental property allowed for income tax purposes is regarded by some aid administrators as inappropriate for need analysis purposes. Allowing depreciation as an expense may understate actual cash flow from rental income. Another approach to the tax losses that frequently appear in rental property cases could be to impute income which represents a reasonable annual yield on the property, reduced by the amount of mortgage payments (both principal and interest).

Royalties. Royalties are generally derived from one of two sources — either (1) from copyrights, patents, and trademarks, or (2) from payments for oil, gas, minerals, or timber extracted from property in which the recipient of the royalty holds an interest. Royalties usually do not produce losses, although in some instances government-approved depletion allowances will reduce royalty income in the second category noted above. Aid administrators usually do not permit depletion allowances to offset royalty income. In some cases depreciation may be claimed on a copyright or patent. Although this is seldom encountered, it may be appropriate to disallow such an offset of royalty income.

Partnerships. Partnership income is reported as a net figure on IRS Schedule E. More detail may be obtained from the partnership return (IRS Form 1065) or from the partner's record of income from the partnership (IRS Form 1065, Schedule K-1). If the partnership is not a major source of income, it may be held by the family as an investment. This is especially true of limited partnership investments, which typically produce sufficient losses to offset any income for tax purposes. These losses are usually derived from depreciation of major capital investments made by the general partners. Although limitations on losses from passive activities apply to such situations, some aid administrators disallow any losses but include as income any ordinary income or guaranteed payments reported on the partner's Schedule K-1.

Estates and trusts. Income from estates and trusts is the net amount derived from assets administered by a fiduciary, such as a bank or trust company. The income may come from interest and dividends, capital gains, real estate, businesses, farms, partnerships, and so forth. Some aid administrators inquire into the nature of the estate or trust to see whether the net distributions reported reflect all the income actually derived. The fiduciary must file a tax return (IRS Form 1041) for the estate or trust. The aid administrator may want to obtain a copy of this form, or at least a copy of the beneficiary's statement of income (IRS Form 1041, Schedule K-1). In addition, the aid administrator may review reported investments to be certain that the estate or trust has been included.

S corporations (small business corporations). Net income from S corporations is also included in IRS Form 1040, Schedule E. An S corporation is a firm with a limited number of stockholders who report the corporation's income on their individual income tax returns, according to their holdings in the business. The corporation's tax liability is also passed on to the stockholders. Sometimes new businesses are organized in this way. Because of the structure of taxation on individuals and corporations under the Tax Reform Act of 1986, there are increased incentives for businesses to be organized as S corporations. The aid administrator may want to collect supplemental information about the corporation, including a copy of the corporate tax return (IRS Form 1120S) or the shareholder's statement of income (IRS Form 1120S, Schedule K-1).

Capital gains (or losses). Capital gains pose a problem in assessing a family's ability to pay for postsecondary education. Because capital gains are a part of the federal definition of total income, they are treated the same as other income in determining the family contribution under the FM formula. Although a capital gain reflects a real cash flow in the year for which it is reported, it nevertheless represents an asset in transition. Frequently the asset is converted almost immediately into another asset. For example, profit realized from the sale of stock must be reported as income in the form of capital gains even though the entire proceeds may have been invested in another enterprise. For this reason there is uncertainty

among aid administrators about whether to treat capital gains as income or assets, or both.

Some aid administrators regard most capital gains not as income, but rather as assets. Indeed, in some instances assets that have made some transition as capital gains may be reported both as income and in their new, transformed, and appreciated state as assets. It is appropriate for the Internal Revenue Service to consider capital gains, because it is only when appreciation is realized as a gain that the tax laws apply. For need analysis purposes, however, they assert that, because the present market value of assets is already considered, it may be inappropriate to "double count" the appreciated value of an asset both as asset and as income. Among aid administrators who take this position, some have the practice of nullifying all capital gains when calculating family income. Others negate capital gains if it appears that they are a one-time occurrence, but include gains if they represent a recurring pattern of income. Another approach is to consider the number of years over which a capital gain has accrued. By dividing the gain by the number of years the aid administrator can approximate the annual income flow represented by the gain. Capital losses are generally disallowed by aid administrators who omit capital gains from family income calculations, on the grounds that a loss is reflected in the diminished present value of a family's assets.

The Tax Reform Act of 1986 eliminated the former distinction between short-term and long-term capital gains. Since 1987, all capital gains are fully taxable. Capital losses, along with losses carried forward from previous tax years, are allowed to offset gains for income tax purposes. As much as $3,000 of a married couple's income may be offset by capital losses. For a single person or a married person filing a separate return, the maximum offset against income is $1,500.

There are special rules that pertain to the sale of a home. There is no capital gain for tax purposes if a new home is bought or built within two years of the sale of a former residence. In addition, if a taxpayer is age 55 or older, he or she may exclude as much as $125,000 from taxable income if married and filing a joint income tax return, or $62,500 if single or filing separately. The special exclusion may be opted for only once in a lifetime and applies only to a residence that has been owned and lived in by the taxpayer during at least three of the past five years. Losses from the sale of a principal residence are not allowed by the Internal Revenue Service, and do not reduce adjusted gross income.

Other taxable income. Other income that may be a part of adjusted gross income includes refunds from state and local income taxes, alimony received, taxable portions of pensions and annuities, unemployment compensation, and other taxable income. It may be necessary to review the family's income tax return and accompanying schedules to get a complete picture of these sources of income.

Refunds from state and local income taxes. These refunds are reported on the federal income tax return only if they come from a prior year in which state and local income taxes were taken as an itemized deduction. The Internal Revenue Service includes refunds in current income because in the prior year the refund was not taxed by virtue of being an itemized deduction. Refunds, however, do not represent new income for the family. Because of this, some aid administrators delete refunds from the family's total income. In addition, unless there is a significant change in the amount of state and local income taxes withheld from earnings, even a recurring pattern of refunds does not reflect a difference in income flow from year to year.

Alimony received. Alimony paid to a taxpayer by a former spouse is a part of adjusted gross income. If the noncustodial parent of a dependent student has provided information to the aid administrator, the custodial parent's alimony figure can be checked with the noncustodial parent's figure. The aid administrator may want to correspond with the parents to clarify any inconsistencies. Differences are sometimes related to each parent's understanding of the nature of the payments. It is frequently the case that the noncustodial parent considers payments made to a former spouse as alimony, which may be subtracted from total income as an IRS "adjustment to income." The receiving parent may regard the payments as child support, which is not subject to taxation as income.

Pensions and annuities. Income from pensions and annuities may be either taxable or untaxed. In general, if contributions to a pension plan were tax-sheltered in a retired person's employed years, the income from the pension will be taxable. Individual Retirement Accounts (IRAs) and Keogh plans are examples of such retirement provisions. If a retired employee contributed to a company's pension plan during his or her working years, the pension benefits are untaxed until the retiree has received benefits equal to his or her contribution. Benefits received in excess of the employee's contribution level are taxable. The untaxed portion of annuity income is related to the ratio of the annuitant's investment to the prospective return on investment.

In general, "rollovers" that are reported on the IRS Form 1040 represent conversion of retirement assets from one form to another, and do not represent income flow. Sometimes, however, families must access

their retirement funds for emergencies or to pay for postsecondary education. In such cases the amount withdrawn will appear on the income tax return as taxable income (and a penalty will be included as an IRS "adjustment to income"). The aid administrator may want to consider whether such retirement resources have been depleted or will continue to be drawn on during "estimated year."

There usually is no question that pension and annuity income should be included in income for need analysis; the question instead is whether all such income has been revealed. The aid administrator may want to inquire about whether all retirement income has been included in the financial aid application if it appears that a family's living costs consume an inordinate part of the family's reported resources.

Unemployment compensation. The Tax Reform Act of 1986 made all unemployment compensation taxable beginning with the 1987 tax year. If there is no indication of when or whether unemployment might end, the aid administrator may want to correspond with the family about its situation and any prospect for new employment. In some instances the aid administrator may want to flag the student's file for review later in the academic year to see if the family's circumstances have changed.

Other taxable income. The final item in the income section of the IRS Form 1040 is a catchall category for miscellaneous other income. This may include honorariums, gambling and lottery winnings, other prizes or awards, and recovered bad debts. Net operating losses, formerly included in this category, were eliminated by the Tax Reform Act of 1986. Some aid administrators do not consider miscellaneous income to be recurring and, therefore, exclude it from income. Others include the income despite its "windfall" character.

Untaxed Income And Benefits

Untaxed income and benefits include social security benefits, Aid to Families with Dependent Children, child support received, and other untaxed income. "Other untaxed income" is sometimes a troublesome item because the family is asked to list aggregate income and benefits for the entire household. It may be difficult to identify those benefits that go directly to the student and separate them from support provided for other family members. Some income in this category may be unreliable because of changes in the level of support or changes in the number of family members supported.

It is sometimes difficult to obtain complete information about benefits received and the current rules governing the various programs. The aid administrator should maintain close contact with students who receive such benefits. It may also be helpful to establish communications with principal public welfare agencies and arrange to be notified about changes in benefit levels and regulations related to eligibility.

Social security benefits. Social security benefits may be paid to an individual who is retired or disabled, or to a parent who is a surviving widow or widower who has dependent children who are under age 18 or who are handicapped or mentally retarded. The aid administrator may want to review application materials to see if either parent is retired or disabled. If a parent is widowed, this is indicated in the FAFSA; however, if the surviving parent has remarried this is not always readily apparent. If there is a stepparent present and it appears not to be a divorced or separated case, it may be appropriate to inquire if social security benefits are received by the family. The aid administrator may also beware of double counting benefits that may be misreported on the FAFSA or other application materials as both parental and student benefits.

Aid to Families with Dependent Children. If AFDC (or ADC) benefits are reported by the family, the aid administrator may want to inquire whether benefits will continue in the academic year. If the benefits will be discontinued, an adjustment in the need analysis may be indicated.

Child support received. Child support may be paid by a noncustodial parent to a custodial parent to held maintain the children of the dissolved marriage. If the parents' marital status is single, separated, or divorced, it may be that child support is received. If no support is reported, the aid administrator may want to investigate whether child support payments have been omitted from the need analysis documents. Some aid administrators require evidence that child support has been sought but is not forthcoming. In some states, public welfare agencies can provide replacement support payments, although this may sometimes occur only on order of a court. If additional information is obtained from the noncustodial parent, the figures reported for child support may be compared with the figures used in need analysis. The aid administrator should attempt to reconcile any discrepancies in the figures. As noted in the earlier discussion of alimony, there may be some confusion over the designation of payments made by one parent to another.

Other untaxed income and benefits. The instructions

in the FAFSA include a list of income items to be reported as other untaxed income and benefits. Some of these have already been discussed; others include:

- Payments to Individual Retirement Accounts (IRAs) and Keogh plans (reported on IRS Form 1040 under "adjustments to income")
- Earned income credit (reported on IRS Form 1040 or 1040A)
- Income tax credit for federal tax on special fuels
- Foreign income exclusion (reported on IRS Form 2555)
- Payments to tax-deferred pension and savings plans (reported on Form W-2 earnings statements)
- Welfare benefits (other than AFDC or ADC)
- Worker's compensation
- Veteran's noneducational benefits (e.g., Death Pension, Dependency and Indemnity Compensation [DIC], etc.)
- Untaxed income in kind (e.g., housing, food, and other living allowances for the military, clergy, and others)
- Cash support or any money paid on the student's behalf (including support from a noncustodial parent or other person)
- Other untaxed income and benefits (e.g., Black Lung benefits, Refugee Assistance, untaxed portions of Railroad Retirement benefits, Job Training Partnership Act noneducational benefits, etc.)

Three forms of untaxed income merit special attention. These are payments to tax-deferred pension and savings plans, foreign income exclusions, and untaxed income in kind.

Payments to tax-deferred pension and savings plans. The Internal Revenue Code (IRC) provides favorable treatment to income set aside for retirement purposes. Under sections 401(k), 403(b), and similar provisions, an employee may exclude from current taxation income that is contributed to a deferred compensation plan or under a salary reduction agreement. These items should be reported on the FAFSA as untaxed income reported. These contributions are reported in Box 17 of Form W-2 with the codes "D" through "H." The meaning of these codes is as follows:

D. Cash deferred compensation agreement — IRC §401(k)

E. Salary reduction for purchase of an annuity contract — IRC §403(b)

F. Salary reduction plan for a "simplified employee pension" (SEP) plan — IRC §408(k)(6)

G. Deferred compensation plan for state or local government employees — IRC §457

H. Deferred compensation plan for a tax-exempt organization — IRC §501(c)(18)(D)

Foreign income exclusions. Foreign income exclusions are not frequently encountered, but they may be substantial. The Internal Revenue Service allows Americans (except federal government employees) residing abroad to exclude as much as $70,000 of foreign income. In addition, they may exclude deductions for employer-provided allowances for housing, schooling expenses, and transportation expenses for home leave. In some instances workers in areas with substandard housing may exclude additional amounts attributable to employer-provided meals and lodging. Aid administrators may want to obtain IRS Form 2555, "Foreign Earned Income," to see whether appropriate amounts have been reported in the FAFSA or other need analysis form.

Untaxed income in kind. In cases in which nonmonetary, in-kind support is provided to a family, the aid administrator may be justified in estimating the value of the housing, food, or other services. Military personnel, clergy, and faculty members may receive housing allowances or subsidies. Military personnel receive quarters allowances that vary by rank. The use of a percentage of salary as a means of estimating the value of housing may be helpful in the case of clergy and faculty. The provision of housing allowances for clergy has been changing. Aid administrators may find it helpful to contact area denominational offices for help in developing reasonable guidelines. Faculty members who pay rents of less than 5 percent of the appraised value of their housing have taxable income equal to the difference, according to the Tax Reform Act of 1986. If the faculty member lives in the housing as a condition of employment, however, it is nontaxable.

Allowances Against Income

After the aid administrator is satisfied that the family's total income has been properly determined, the allowances against income should be reviewed.

U.S. income tax paid. The amount of U.S. income tax paid can provide a crosscheck for taxable income. In cases in which the U.S. income tax paid is significantly higher or lower than the standard tax, the aid administrator may want to ask for more detailed income and tax figures or request a copy of the income tax return with appropriate supplements. These materials may explain the unusual situation and document the legitimacy of a variance from the standard calculation.

Sometimes families report the tax withheld (as recorded on W-2 forms) on the FAFSA instead of the actual tax paid. In other instances, they may include miscellaneous taxes, such as FICA tax for self-employment. A discrepancy may also arise from errors made because the family did not read the instructions carefully or because the FAFSA was completed before the income tax return was completed.

In cases of separation, divorce, or death of a parent, or if estimated year income is used, it may be necessary to recalculate or project the income tax figure. It is not necessary in such cases to use a standard tax amount if it is clear that the family has a significantly smaller tax liability than that calculated by using the standard deduction. The most recent figure for tax paid can be used as an indicator of the proportion of income that was or will be paid as taxes. This procedure is especially appropriate for families with substantial itemized deductions or IRS adjustments to income. Follow-up verification of actual tax paid is always preferable to using a projected tax figure.

Care should be taken in reviewing the applications of American nationals living abroad. A standard calculated tax may well be larger than the amount actually paid. In such cases the aid administrator may want to confirm any taxes paid to a foreign country as well as the amount of U.S. income tax.

State and other taxes. The allowance for state and other taxes is based on the family's total income and state of residence. In some cases employment may be in a metropolitan area that imposes local income taxes or employment may carry family members across state boundaries. In such cases, the student's family may be subject to more than one state or local tax, and adjustments for institutional purposes may be appropriate. The state and other income taxes figure may be reported on IRS Form 1040, Schedule A.

FICA taxes. Standard need analysis procedures base the FICA tax calculation on the earnings of each parent, using the tax rate applicable to persons employed by others. If a parent is self-employed, he or she pays a FICA rate twice that of a person employed by others; however, one-half of the FICA tax is allowed as an "adjustment to income" in calculating adjusted gross income. Because of this, the FM formula allowance is appropriate for both self-employed persons and those employed by others. If there is need to calculate a FICA tax for a self-employed person, care should be taken to use the applicable, higher rate.

Employment allowance. The employment allowance is based on 35 percent of the lower income from employment in a two-parent family or the only income in a one-parent family, to a maximum figure that is adjusted annually. For 1993-94 it is $2,500, and is based on "the marginal differences in costs for a two-earner family compared to a one-earner family for meals away from home, apparel and upkeep, transportation, and housekeeping services" (*Federal Register*, 58:101, May 27, 1993, p. 30912).

For institutional purposes, if a parent is employed in the home, some aid administrators will reduce or eliminate the allowance. They justify their action by noting that the allowance presumes employment outside of the home. Yet other aid administrators reduce the allowance if a parent is employed only part-time. The assumption that part-time employment necessarily implies partial employment costs, however, may not always be correct.

Some parents have additional employment costs that are not reflected (or at least not fully reflected) in the employment allowance. These costs may include child care, union dues, uniforms and other work clothes, tools, and so forth. In addition, some employees have business expenses for travel, food, and lodging that are not reimbursed by their employers. These costs may be deductible for income tax purposes if, in combination with other miscellaneous itemized deductions, they exceed 2 percent of AGI. Details of such expenses are provided on IRS Form 2106, "Employee Business Expenses."

Income protection allowance. The income protection allowance is based on the family size and number of family members in college. If either of these figures has been changed, the income protection allowance should be adjusted.

The allowance figures are derived from national data about the cost of living that are reflected in the Bureau of Labor Statistics lower budget standard. For institutional

purposes, the financial aid administrator may want to adjust the allowance for cost-of-living differences in various parts of the United States. The Bureau of Labor Statistics annually publishes updates of its indexes of living costs for major metropolitan areas and various regions of the country.

Medical and dental expenses. The FM formula makes no provision for unusually high medical and dental expenses. Nevertheless, it is Congress' intent that such expenses be considered under professional judgment. Under the former Congressional Methodology, an allowance was made for medical and dental expenses that exceed 5 percent of the family's total income. Such an allowance would be appropriate under the RA formula.

The aid administrator should be alert to the possibility that expenses for medical or dental treatment are reported but that the insurance reimbursement has been omitted. In addition, although medical insurance premiums are legitimate allowances for need analysis purposes, care should be taken to see that these (and other medical and dental expenses) are not paid through IRS-approved income-reduction plans that are not reported as untaxed income.

In most instances of unusually high medical and dental expenses incurred by taxpayers, the total amount will be included in IRS Form 1040, Schedule A. However, because of a threshold of 7.5 percent of AGI, some families will omit entries for these expenses even though they may be sizable enough for consideration in need analysis.

In the case of longer range medical and dental care, such as psychiatric expense, cancer therapy, or orthodontic work, only the current annual costs should be reported. Extremely large or accumulated expenses should be carefully reviewed for appropriateness. One possible treatment of large indebtedness for medical and dental bills is to consider the indebtedness as an allowance against assets. In some instances, this more clearly approximates the family's actual cash flow because they may not be able to repay the medical debt during the one year on which the aid application is based.

See Appendix D, Unusual Medical and Dental Expenses.

Unreimbursed elementary and secondary school expenses. The FM formula makes no provision for unreimbursed elementary and secondary school expenses, but Congress intended that such expenses be in the province of aid administrators' professional judgment.

The former Congressional Methodology provided an allowance for elementary and secondary school expenses that exceeded a maximum allowance for each dependent child. The allowance ceiling was revised annually according to the national average per pupil cost of public elementary and secondary instruction. A similar, updated allowance would be appropriate under the RA formula.

Even so, there is a wide range of opinion about the allowance. What is at issue for some aid administrators is whether the family has exercised discretion in incurring expenses that reduce their available resources. In general, discretionary decisions that reduce the expected family contribution are treated differently in need analysis from expenses incurred about which the family has no choice.

The family's decision, particularly when a religious school is involved, may be the factor that determines whether the allowance is permitted. Other considerations may be whether the child is required to attend a particular elementary or secondary school for medical, emotional, physical, or perhaps even academic program reasons. In any of these cases it may be appropriate to grant an allowance for elementary or secondary tuition expenses. On the other hand, when awarding limited funds to needy students, the financial aid administrator may elect to reduce or eliminate the allowance if attendance at a particular school is one purely of individual choice.

Care should be exercised in establishing an institutional policy concerning the elementary and secondary expenses allowance. Such a policy should reflect the institution's philosophy and should be consistently applied.

See Appendix D, Elementary and Secondary School Costs.

Other allowances. Allowances for other expenses may be made for institutional purposes; for federal purposes, however, such expenses must meet the test of "unusual circumstances" established in statute. Establishing a list of generally allowable expenses can simplify the task of processing applications and help ensure consistency of treatment. A key element that should be considered in evaluating potential allowances is whether the expenditures are voluntary or involuntary. Clearly, nondiscretionary expenses incurred by the family should be allowed. Examples include child support payments (however, note that parents are directed in the FAFSA to exclude these from their reported income), funeral expenses, legal fees, and moving expenses. Optional expenditures, on the other hand, may require a judgment by the aid administrator as to whether such expenditures should take priority over postsecondary education in the family's budget.

Also see, Appendix D, Child Care and Dependent Care Costs.

Adjustments to income. The Internal Revenue Service allows several kinds of expenses to be excluded from taxable income as "adjustments to income." These include contributions to IRA and Keogh retirement plans, penalties for early withdrawal of funds from time savings accounts, alimony paid, and, for self-employed persons, one-half of self-employment FICA taxes and as much as one-fourth of health insurance premiums.

IRA payments may be fully subtracted as adjustments to income by taxpayers with gross incomes of less than $25,000 (or $40,000 for joint returns). A portion of IRA payments may be subtracted by taxpayers with incomes less than $30,000 (or $50,000 for joint returns). The FAFSA instructions call for IRA and Keogh payments to be included in untaxed income. The rationale is that payments to IRA and Keogh plans are voluntary, or discretionary, expenditures for many families and, therefore, should be included in total income for need analysis purposes.

Depending on the individual family's circumstances, the financial aid administrator may wish to consider modifying the treatment of payments to IRA/Keogh programs in determining the family contribution for institutional purposes. One alternative is to include the IRA/Keogh payments as assets rather than as income, thereby allowing these payments to be protected for retirement purposes like other assets. Another approach the financial aid administrator may consider depends on whether there is another, employer-sponsored retirement plan. If no other retirement program is available, the financial aid administrator may consider allowing the IRA/Keogh payments as allowances against family income.

Available income

The family's available income is calculated by subtracting the total allowances from total income. The remainder, if any, is presumed to be available for discretionary and supplemental spending (including postsecondary education) beyond the minimum level of support provided by the income protection allowance, which is based on the Bureau of Labor Standards lower budget standard.

Parents' Assets

In reviewing a family's assets, the aid administrator should keep in mind that it is logical to expect that assets are held by a family for some economic advantage. Assets should appreciate in value, produce income, or provide a benefit, such as shelter or a tax advantage. In many instances they do all of these. For this reason assets should be examined with an eye to their interrelationship with income or the benefits derived from them.

The greatest differences between the FM and RA formulas are in treatment of assets. For FM formula purposes, parents' (and student's) assets are excluded from consideration under the "simplified needs test" if the parents' adjusted gross income is less than $50,000 and the family does not file an IRS 1040 income tax return (or is not required to file a U.S. income tax return). For RA purposes, the aid administrator may want to consider parents' and student's assets in need analysis. (It should be noted that the Higher Education Act automatically includes in the "simplified needs test"/"no-assets" category all residents of Puerto Rico, the Virgin Islands, and other U.S. territories who do not file a U.S. income tax return, regardless of their income level.)

Cash, savings, and checking accounts. The aid administrator may want to compare the amount reported for cash, savings, and checking accounts with interest income reported on income tax returns. If the yield rate does not seem reasonable, some aid administrators impute a value using the interest figure as the basis for the calculation. Others consult the family to reconcile the apparent discrepancy. If an inordinately large amount of cash is reported, the aid administrator may want to ascertain whether any major outlays are expected in the near future. For renewal cases, this item serves as a barometer of the family's cash flow and life style while paying for education. Severe fluctuations from year to year may indicate either excessive harshness or generosity in the previous need analysis and adjustments may be considered.

Home equity. Home equity is eliminated from the FM formula beginning with the 1993-94 award year. For institutional purposes, however, the financial aid administrator may want to include this asset.

Home equity is calculated by subtracting any outstanding mortgage or other debt from the home's present market value. Some aid administrators have the practice of using the purchase price of home and its year of purchase to check the family's figures against a national table of real estate appreciation. It should be noted that home values may be affected by a number of factors that are not reflected in national tables. Depressed housing markets in particular parts of the country, neighborhood deterioration, and industrial or highway encroachment are some reasons for slower appreciation or even a reduction in value. In addition, mobile homes generally depreciate in value in the same way that motor vehicles do.

Some aid administrators are especially concerned about the role that home equity plays in the expected family contribution. Some will reduce the family contribution in cases in which they believe home equity (or other illiquid assets) has too great an impact on the expected contribution. The justification for such adjustments is the reasonableness of the calculated contribution in the professional judgment of the aid administrator. Others contend that, because of the substantial benefits realized from owner-occupied housing and the availability of loans based on appreciated home equities, it is inappropriate to discount the expected family contribution because of home equity.

Another consideration is that some states (e.g., Texas) limit or do not permit home equity credit lines or second mortgages, thereby eliminating a possible family resource for college costs. In addition, the aid administrator may weigh whether it is reasonable to include a contribution attributable to home equity based on the feasibility of the family's accessing this asset (i.e., would the family's income or existing debt levels permit a lender to approve a home equity credit line or second mortgage?).

In divorced or separated situations, the aid administrator should be certain that the parent has properly reported his or her proportionate share of the home market value and debt. If a separation agreement or final divorce decree is pending, and the home or other assets have not yet been divided, it may be appropriate to assume an even division until final action has been taken.

Other real estate equity. The possession of other real estate (other than the home) usually means that some income may be expected from it. This is not always the case, as in the case of undeveloped land or a second or vacation home that is not rented out. If income is produced, however, it should be included in adjusted gross income. If more information is needed, it should be requested from the family.

Some aid administrators impute an income from other real estate using a factor similar to the rate of return on other investments. Their position is that it is reasonable to assume that property held for investment purposes should be as economically productive — in terms of income and appreciation — as other forms of investment.

The purchase price and year of purchase of other real estate may be used to assess whether the reported value shows reasonable appreciation. An appreciation table for commercial properties is published annually by the United States Department of Commerce. It should be noted, however, that because of economic conditions in a particular locale or region, real estate values may in fact decline. In such a situation it may be economically infeasible for a family to dispose of a property (even if they wanted to do so) without realizing a substantial loss.

Investments. Investments may be compared with interest and dividend income to see if a reasonable yield is reported. If there is an apparent discrepancy, some aid administrators may impute a reasonable return on investments. Others may correspond with the family to resolve the matter. Aid administrators should be aware that there may be wide fluctuations in the value of investments and the return on them. In some cases the aid administrator may want to adjust the asset conversion rate for institutional purposes to prevent a kind of "double taxation." This is especially the case if the standard analysis derives all or a large portion of the family income — and thus the family contribution — from investment income. This may be of particular concern in cases involving widowed parents.

In some instances investment income may be reported without a clear indication of its source. This may indicate income from a trust, estate, or insurance policy. The family may not have unlimited access to the corpus of a trust or the assets of an estate. The aid administrator should determine the beneficiaries in these cases and the degree of flexibility or inviolability of the assets. This information may be used for institutional purposes in the discretionary treatment of other assets or in the amount and kind of financial aid ultimately offered to the student. If the aid administrator believes that the family has neglected to report all of its income-producing assets, clarification should be sought from the family. Special consideration may be needed in cases in which there has been a recent death because it may be too early to obtain a full evaluation of assets.

Other forms of investment, such as holdings in precious or strategic metals, commodity options, and money market accounts, may not produce interest or dividends. Such assets should be included in need analysis, but it may be inappropriate to impute any income flow from them. Yet other assets, such as antiques, jewelry, and artworks, may in fact have been acquired as investments but are usually excluded from need analysis.

Business and farm. Beginning in the 1993-94 award year, the FM formula eliminates consideration of farm assets if the family resides on the farm. Nevertheless, for institutional purposes, the financial aid administrator may want to include farm assets.

Business and farm assets may require careful review by the aid administrator. In the earlier discussion of business and farm income, it was noted that financial dealings of the business or farm, including transactions with the owners or others, may affect the assets of the enterprise. For example, net profit from a business or farm may be transferred to assets as cash on hand or

retained earnings. The schedule of depreciation allowed for income tax purposes may be helpful in confirming the values of some business or farm assets. It should be remembered, however, that land may not be depreciated and that fully depreciated assets will not appear on depreciation schedules.

In some instances, the worth of a business or farm may have decreased. If the productivity of the land or business has declined over time or some external factor has made the business or farm less desirable, the family may report a diminished worth of the farm or business. Partnerships or corporations in which there is only a small share of ownership may create similar problems because the family cannot control business or farm activities. Sometimes a family cannot dispose of an asset because of the restrictions of a trust or complications arising from an estate.

The aid administrator may also consider the debt-to-asset ratio of a business or farm enterprise. The same net worth value may represent an entirely different picture of the fiscal health of a business or farm depending on the debt-to-asset ratio. For example, an enterprise with a net worth of $100,000 may represent a comparatively small operation with no debt (a zero debt-to-asset ratio) or a much larger operation with an inordinate debt (e.g., a $1,000,000 business with a $900,000 debt — a 90 percent debt-to-asset ratio). The latter enterprise may be in financial distress because its ability to generate capital for operating expenses is limited by its debt (and maintenance of the debt). Another way of measuring the financial health of an enterprise is to calculate the rate of return on equity. If an enterprise does not generate net income equal to a reasonable return — that is, similar to the return on other forms of investment — then the financial aid administrator may weigh whether it is realistic to view the enterprise as a source of support for a calculated contribution.

Pension assets. Some aid administrators, for institutional purposes, collect additional information about families' provisions for retirement. Some aid administrators include accumulated, vested pension assets in the family's net worth. Others reduce or eliminate the parents' asset protection allowance if substantial assets are found. Their justification is that the asset protection allowance is theoretically based on the retirement needs of the parent or parents and the assumption that the only retirement provision is social security benefits. If there are other provisions, it is argued, the protection allowance should be reduced.

Consumer and educational indebtedness. Although consumer debt and personal possessions are not typically taken into account in need analysis, it is possible to use this information for institutional purposes if the family is heavily in debt but making strides to overcome the situation. Debts should be thoroughly reviewed for appropriate justification. The aid administrator should be aware of how the indebtedness is distributed among creditors and may disallow indebtedness for discretionary purchases, such as automobiles, boats, recreational vehicles, and so forth. Some families will show large indebtedness because of previous loss of income from extended unemployment, illness, or business failure. Special consideration may be given in such cases. Educational debts of the parents for their own education and current year payments required for other educational obligations (e.g., Federal PLUS loans) may also be included at the aid administrator's discretion.

See Appendix D, Unusual Debts.

Parents' Contribution From Assets

The role that assets play in the total family contribution should be a reasonable one. By evaluating the relationship between asset strength and current income, the aid administrator can identify situations in which the expected contribution is not feasible. For institutional purposes, it may be deemed necessary to adjust the asset protection allowance or asset conversion rate in cases involving retired parents, a widow or widower, or a parent with a terminal or debilitating illness.

Parents' Contribution For The Student

If adjustments are made in the family's income, allowances, or assets, it is necessary to recompute the parents' contribution for the student based on the revised adjusted available income and the number of family members in college.

In the earlier section on number of family members in college, procedures for reviewing the number were discussed. Once the number in college is determined, the standard procedure is to allot an equal portion of the total parents' contribution to each family member in college. This procedure, however, does not differentiate between higher and lower cost institutions. An alternate approach for institutional purposes that recognizes this difference is for the aid administrator to distribute the total parents' contribution according to the cost of education at each of

the family members' colleges. For example, if the total parents' contribution is $8,000 and two children attend colleges costing $3,000 and $12,000 respectively, the calculated parents' contribution would $4,000 for each student. Some aid administrators, however, regard the parents' contribution to be limited to $3,000 at the lower-cost college, and hold that the "excess" $1,000 in contribution could be used by the other child. The parents' contribution, therefore, would be $5,000 at the higher-cost college.

An alternative is for the aid administrator to divide the parents' contribution proportionately, based on the comparative costs of the institutions attended. Using the previous example, 80 percent (that is, $12,000 divided by $3,000 plus $12,000) of the parents' contribution would be applied to the expenses of the child enrolled at the higher-cost college and the remaining 20 percent to the sibling's expenses at the lower-cost institution.

Some aid administrators use an assessment rate schedule for multiple family members in college that assumes a total family contribution greater than 100 percent of the calculated contribution for one family member in college. For example, the contribution might be 120 percent for two in college (60 percent of PC each), 135 percent for three in college (45 percent each), and 150 percent for four or more in college (37.5 percent each for four in college).

Dependent Student Issues

For single dependent students the standard need analysis procedures should apply in most cases. Professional judgment is exercised primarily in determining whether all resources have been reported and the appropriateness of the information. Contributions are expected from the student's income and assets.

Contribution from income. The FM formula revised the calculation of the dependent student's contribution from income beginning with the 1993-94 award year. The formula uses essentially the same definition of income as is used for dependent students' parents. To determine "available income" U.S. income tax paid, allowances for state and local taxes and FICA taxes, and an income protection allowance of $1,750 are subtracted from the student's total income. The contribution from income is calculated by applying a 50 percent assessment rate to available income.

For institutional purposes, the aid administrator may want to preserve some aspects of the former Congressional Methodology, which made no provision for an income protection allowance for dependent students and assessed available income at a 70 percent rate. Even more notable, however, was the Congressional Methodology's minimum income contribution for dependent students of either $700 for freshmen or $900 for other students.

Because the student contribution from income is based on the preceding calendar year, the aid administrator may want to review the calculated figure to see if it is realistic. A student may not have the expected contribution because of illness, family needs, academic pursuits that precluded work, or the inability to find employment. If the student does not have the contribution, the aid administrator may adjust the expected figure to reflect the student's actual circumstances.

The possibility also exists that a student will produce higher income in the estimated year. There are two views among aid administrators about dealing with such situations for institutional purposes. One view would allow the student to retain excess earnings without modifying the need analysis or aid package. The other view requires at least a minimum institutional expectation (if there is one) but would use any additional earnings as a resource in need analysis. If either approach is adopted for institutional purposes, it should be applied consistently so that all applicants receive equitable treatment. If the additional earnings are counted as a resource, it should be remembered that it is a form of self-help, and that the subsequent reduction in aid eligibility perhaps should come from either loans or employment in the package.

Veterans' educational benefits. If a dependent student receives veterans' educational benefits (e.g., under the Restored Entitlement Benefits for Survivors, Section 156, or Dependents Educational Assistance Program, Chapter 35), these are not included in income for need analysis purposes. Rather, beginning with the 1993-94 award year, such benefits are regarded as a direct student resource. Information about veterans' educational benefits is collected on the FAFSA.

Contribution from student's assets. Thirty-five percent of a student's assets are deemed available as a contribution toward postsecondary expenses.

If substantial assets are reported by the student, some aid administrators will inquire about the nature of the assets before they make any decisions about the student's contribution from assets.

Student assets that are the product of parental savings may, for institutional purposes, be moved to parental assets, thus providing a larger measure of protection for those assets in recognition of their source. For example, assets may have been placed in the student's name by his or her parents under the Uniform Gift to Minors Act in order to take advantage of reduced income taxes on

unearned income produced by the assets. Some aid administrators will regard all of these assets as a parental resource; others will "cap" the assets at an arbitrary level (such as $5,000) and assign the remaining assets to the parents in need analysis. If the student has siblings, some aid administrators ask the parents whether similar family assets are held by the student's brothers and sisters as well.

A student's assets held in trust can be viewed in various ways, depending on the terms of the trust. If the trust cannot be invaded for educational purposes, it may be appropriate to reduce the contribution and use a correspondingly higher proportion of self-help aid (loan or work) in the aid package.

If the student will be enrolled for less than four years, the aid administrator may want to increase the contribution from student's assets to reflect the length of the program of study.

Independent Student Issues

The structure of need analysis for independent students varies according to the nature of the student's family responsibilities. The 1992 amendments of the Higher Education Act shifted treatment of married students without dependents (other than a spouse) from paralleling the treatment of dependent students' parents to paralleling the treatment of single independent students (without dependents other than a spouse).

Independent students without dependents (other than a spouse) — i.e., single and married independent students with no children or other dependents. The contribution from income parallels the procedures cited above for dependent students' own resources with the following exceptions:

- The income protection allowance is $3,000 for an unmarried student or a married student whose spouse is enrolled at least half-time; $6,000 for a married student whose spouse is not a student or is enrolled as less than half-time student.
- An employment allowance is granted if the student is married and both the student and spouse are employed.
-
- The "simplified needs test" excludes student's (and, if applicable, spouse's) assets if the AGI is less than $50,000 and a U.S. IRS 1040 was not or will not be filed (or was not required to be filed).
- The expected family contribution is divided by number in college if the student is married and the spouse is at least a half-time student.

Independent students with dependents (other than a spouse). The family contribution for independent students with dependents (other than a spouse) is calculated in the same way that the parents' contribution for dependent students is calculated.

Marginal assessment rates on taxable income. The FM formulas for independent students apply marginal assessment rates to the student's available income that assess only a portion of total income. These provisions have budget construction implications. Institutions should use budgets that represent "minimum costs" for the student. Additional expenses, which supplement the basic budget, may be covered by the portion of a student's earnings that are not assessed by the FM formula. In this way the marginal assessment rates on available income provide incentives for a student to seek employment. As a student's earnings increase, part of the increase is available to bolster his or her standard of living.

Alternate approaches to determining an independent student's contribution from income. For institutional purposes, some aid administrators argue that because the student is the primary beneficiary of the educational endeavor, all of the student's (and family's) resources should be expected to help meet a comprehensive expense budget that provides for direct educational costs of the students as well as modest living expenses. Others suggest that at upper income levels higher assessment rates should be used. If the aid administrator makes adjustments to the assessment rates on the student's taxable income, there may be budget construction considerations that should be examined concurrently.

Minimum contribution from income. For institutional purposes, a minimum contribution from income may be expected from the student (and spouse). The Congressional Methodology level was $1,200. Despite this, the aid administrator may exercise professional judgment in setting aside or altering the expectation. Reasons for doing this may include the following:

- Local economic and employment conditions;
- Medical reasons that preclude the student (or spouse) from being employed;
- Disability of the student (or spouse) that may limit or restrict earnings; and/or

- Any factor that may limit or impede the student's earning potential.

The aid administrator should carefully review the individual circumstances to determine if, for institutional purposes, the student's contribution is reasonable because of factors that are beyond the control of the student.

Estimated income versus previous income levels. The aid administrator may want to compare a student's projected income for the "estimated year" (i.e., the calendar year following the "base year") or the award year with the base year income reported on the FAFSA. It may be appropriate to adjust the expected contribution because of a student's change of status from full-time worker to student and part-time worker. It may be necessary to collect relevant information about the estimated year, such as projected average weekly hours of work, rate of pay, tips (if occupation warrants), and periods of unemployment. Pay stubs, W-2 forms, and employer contracts are useful for subsequent verification of the projections. Federal Work-Study and other forms of aid should not be included in student's or spouse's income.

Student's untaxed income and benefits. In reviewing untaxed income and benefits, the aid administrator should check to be certain that all such sources of income are reported. It may be appropriate to request documentation from the relevant agencies in order to confirm the benefit levels. In some instances a student may have unreported benefits, such as Medicaid, child care, fuel assistance, or housing benefits. Note that in some instances regulations governing benefits (e.g., food stamps) may specifically prohibit their inclusion as a student resource for need analysis purposes. Often professional judgment must be exercised in the need analysis, budget construction, and subsequent packaging of aid.

Veterans' educational benefits. Beginning with the 1993-94 award year, veterans' educational benefits are no longer included in the FM formula. Instead, these benefits are to be considered a direct resource that reduces the student's eligibility. Information about veterans' educational benefits for the award year is collected on the FAFSA.

Student's and spouse's assets. The asset treatment for independent students employs different asset assessment rates depending on whether the student has dependents (other than a spouse). Independent students with dependents have their assets assessed in the same way that assets of the parents of dependent students are assessed. For independent students without dependents, a 35 percent asset taxation rate applies.

It may be argued for institutional purposes that, because an independent student is the primary beneficiary of his or her education, the taxation rate should be higher than that of a dependent student's parents (12 percent). Questions the financial aid administrator may ask regarding the appropriateness of the family contribution from assets might include:

- Should the number or age of dependent children have any bearing on the student's contribution from assets?
- Should the liquidity of the family's assets be a factor in determining the student's contribution from assets?
- Should catastrophic occurrences (e.g., terminal illness) have an impact on the asset protection allowance or assessment rate?
- Has the net worth of any asset decreased substantially since the time that the student filed the financial statement?

Children of Divorced or Separated Parents

Considerations in determining institutional policy. Given the increase in the number of students with divorced or separated parents, aid administrators must give careful consideration to establishing an institutional policy that ensures equitable and consistent treatment of all students. These situations require a particular sensitivity to individual circumstances and to the collection of additional information. Some questions to consider in establishing institutional policy in this area are:

- Should both natural parents have a responsibility to contribute to their children's education, regardless of marital status?
- Should parental responsibility always be based on measured ability to pay, rather than willingness, even with institutional funds only?
- Should parental responsibility be a moral responsibility that goes beyond any legal agreement that has been executed?
- Should the length of time since a divorce or separation affect the responsibility of the parents to contribute to their children's education?
- Should stepparents, with whom the applicant resides,

always have support responsibility? What if there is a prenuptial agreement that precludes a stepparent's contribution?

- Should guardianship be an indicator of economic responsibility for the student?

Calculating the family contribution. After assembling all necessary information (or an explanation for nonresponses to requests for information), the financial aid administrator should decide whether it is appropriate to expect a parents' contribution from both the custodial parent and stepparent. If this is the case, the usual need analysis procedures are followed. There should be no contribution expected from the noncustodial parent beyond what may be paid in child support. On the other hand, if the aid administrator believes that it is appropriate to expect a parental contribution from both the custodial and noncustodial parents, the situation is more complex. Separate analyses may be performed on each family unit, taking into account the family situation in each instance. Each resulting parents' contribution can be apportioned according to the parents' respective shares of their new family's resources. Each parent's separate share can be divided among any children in college. If the custodial parent is not employed and does not have substantial assets, the aid administrator must judge whether any contribution can be expected. If the stepparent's income places the family at a moderate standard of living, a contribution at least equal to basic maintenance can be expected. If the family's income is larger, somewhat more can be expected as a contribution.

Alimony and child support. The Internal Revenue Service treats alimony as income for the receiving parent and as an adjustment to income for the providing parent. Child support received is not considered taxable income for IRS purposes, and neither is it allowed as a tax deduction for the providing parent.

Instead of treating child support as untaxed income for the receiving parent, 75 percent of the child support may be applied as a direct resource for the applicant for a nine-month budget. The amount of child support is not necessarily a ceiling on the contribution from either parent. As suggested earlier, in the case of divorced or separated parents, there may be additional support being provided (or at least available) from the noncustodial parent beyond any alimony or child support payments required by a court decree.

Conclusion

This publication outlines numerous circumstances in which the aid administrator may be called upon to exercise professional judgment. The financial aid administrator is expected to provide leadership in the development of institutional policies and guidelines for exercising professional judgment and to ensure the consistent application of those policies. When questions arise involving professional judgment, the financial aid administrator may find it helpful to consult colleagues at similar institutions. A continuing dialogue among financial aid administrators will prove beneficial in refining professional judgment, with the objective of serving our students more equitably and compassionately.

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Appendix A

HIGHER EDUCATION ACT of 1965, *As Amended*

Section 479A. DISCRETION OF STUDENT FINANCIAL AID ADMINISTRATORS.

(a) In General. — Nothing in [Part F, "Need Analysis"] shall be interpreted as limiting the authority of the financial aid administrator, on the basis of adequate documentation, to make necessary adjustments on a case-by-case basis to the cost of attendance or the values of the data items required to calculate the expected student or parent contribution (or both) to allow for treatment of an individual eligible applicant with special circumstances. However, this authority shall not be construed to permit aid administrators to deviate from the contributions expected in the absence of special circumstances. Special circumstances shall be conditions that differentiate an individual student from a class of students rather than conditions that exist across a class of students. Adequate documentation for such adjustments shall substantiate such special circumstances of individual students. In addition, nothing in [Title IV] shall be interpreted as limiting the authority of the student financial aid administrator in such cases to request and use supplementary information about the financial status or personal circumstances of eligible applicants in selecting recipients and determining the amount of awards under [Title IV]. No student or parent shall be charged a fee for collecting, processing, or delivering such supplementary information.

(b) Adjustments to Assets Taken Into Account. — A student financial aid administrator shall be considered to be making a necessary adjustment in accordance with subsection (a) if —

(1) the administrator makes adjustments excluding from family income any proceeds of a sale of farm or business assets of a family if such sale results from a voluntary or involuntary liquidation; or

(2) the administrator makes adjustments in the award level of a student with a disability so as to take into consideration the additional costs such student incurs as a result of such student's disability.

Appendix B

BRIEF DESCRIPTION OF COMMON FEDERAL TAX FORMS

Form	Title	Description
1040	U.S. Individual Income Tax Return	Self explanatory.
1040A	U.S. Individual Income Tax Return	Short version of 1040.
1040EZ	Income Tax Return for Single Filers With No Dependents	Specialized version of 1040A.
1065	U.S. Partnership Return of Income	Self explanatory.
1120	U.S. Corporation Income Tax Return	Self explanatory.
1120A	U.S. Corporation Short-Form Income Tax Return	Short version of 1120.
1120S	U.S. Income Tax Return for an S Corporation (Small Business)	Specialized version of 1120A.
2106	Employee Business Expenses	Computation of allowances for expenses such as lodging, meals, entertainment, and transportation.
2119	Sale of Your Home	Self explanatory.
2120	Multiple Support Declaration	Indicates a person who paid less than half of a dependent's support will not claim that dependent.
2350	Application for Extension of Time to File U.S. Income Tax Return (for U.S. Citizens and Resident Aliens Abroad)	Self explanatory.
2441	Child and Dependent Care Expenses	A computation to reduce tax liability for qualified taxpayer.
2555	Foreign Earned Income	Reports foreign earned income and/or housing exclusion (U.S. citizens and resident aliens only).
2688	Application for Additional Extension of Time to File U.S. Individual Income Tax Return	Self explanatory.
3468	Investment Credit	Shows computation of tax credit for selected activities.
3800	General Business Credit	Shows computation of tax credit for selected activities.
3903	Moving Expenses	Self explanatory.
3975	Tax Practitioner Annual Mailing List Application and Order Blank	Used to request Package X -- Informational Copies of Federal Tax Forms.
4136	Credit for Federal Tax Paid on Fuels	Computation of credit for federal tax on fuels.
4137	Social Security and Medicare Tax on Unreported Tip Income	Self explanatory.
4255	Recapture of Investment Credit	Shows tax on selected activities which under earlier circumstances received a credit.
4506	Request for Copy of Tax Form	Self explanatory.
4562	Depreciation and Amortization	Details depreciation schedule of properties.
4684	Casualties and Thefts	Details losses.
4782	Employee Moving Expense Information	Self explanatory.

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4797	Sale of Business Property	Reports gains/losses from sale or exchange of business property and reports involuntary conversion and recapture of property. Performs similar function as Schedule D.
4835	Farm Rental Income and Expenses	For taxpayers who rent out farm property. Form may show profit or loss.
4868	Application for Automatic Extension of Time to File U.S. Individual Income Tax Return	Self explanatory.
4952	Investment Interest Expense Deduction	Reports expense deduction for investment interest.
4972	Tax on Lump-Sum Distribution	Reports taxable lump-sum distributions from retirement plans.
5329	Return for Additional Taxes Attributable to Qualified Retirement Plans (Including IRA's), Annuities and Modified Endowment Contracts	Self explanatory.
5754	Statement by Person(s) Receiving Gambling Winnings	Self explanatory.
6251	Alternative Minimum Tax - Individuals	A tax on high-income taxpayers with substantial deductions.
6252	Installment Sale Income	A computation of capital gain spread over time.
8283	Noncash Charitable Contributions	Self explanatory.
8308	Report of a Sale or Exchange of Certain Partnership Interests	Self explanatory
8332	Release of Claim to Exemption for Child of Divorced or Separated Parents	Shows that custodial parent agrees not to claim a dependent - allows non-custodial parent to do so.
8453	U.S. Individual Income Tax Declaration for Electronic Filing	Lists only total income and taxes.
8582	Passive Activity Loss Limitations	Reports limitations on passive activity loss.
8586	Low-income Housing Credit	Self explanatory.
8594	Asset Acquisition Statement	Self explanatory.
8606	Nondeductible IRA Contributions, IRA Basis, and Nontaxable IRA Distributions	Self explanatory.
8615	Tax for Children Under 14 Who Have Investment Income of More Than $1,100	Self explanatory.
8814	Parent's Election to Report Child's Interest and Dividends	Self explanatory.
8815	Exclusion of Interest from Series EE U.S. Savings Bonds Issued After 1989	Shows excludable savings bond interest for filers with qualified higher education expenses.
8818	Optional Form to Record Redemption of Series EE U.S. Savings Bonds Issued After 1989	Self explanatory.
8825	Rental Real Estate Income and Expenses of a Partnership or an S Corporation	Self explanatory.
8829	Expenses for Business Use of Your Home	Self explanatory.
W-2	Wage and Tax Statement	In addition to wages earned and taxes withheld, it shows a variety of uncollected taxes and contributions or payments not included in wages.

BRIEF DESCRIPTION OF COMMON FEDERAL TAX SCHEDULES

Schedule	Form	Title	Description
Schedule A	1040	Itemized Deductions	Medical and dental expenses, taxes paid, gifts to charity, casualty and theft losses, moving expenses, job expenses, and miscellaneous deductions.
Schedule B	1040	Interest and Dividend Income	Includes domestic and foreign interest and dividends.
Schedule C	1040	Profit or Loss from Business	Gives income/loss and deduction details for a sole proprietor operating a business or practicing a profession.
Schedule C-EZ	1040	Net Profit from Business (Sole Proprietorship)	Schedule C short version. When gross receipts are $25,000 or less, business expenses of $2,000 or less, no employees, no inventory, no net loss, only one business as sole proprietor, not required to file Form 4562, and do not deduct expenses for business use of home.
Schedule D	1040, 1065, 1120S	Capital Gains and Losses	On the sale or exchange of personal capital assets such as stocks, bonds, other securities, and real estate. May include previous years' losses.
Schedule E	1040	Supplemental Income and Loss	Rental real estate, royalties, partnerships, estates, trusts, small business corporations, real estate mortgage investment conduits, and windfall profits.
Schedule EIC	1040, 1040A	Earned Income Credit	A negative tax available to qualified low-income taxpayers with children living at home, which may result in taxpayer receiving a refund greater than tax paid.
Schedule F	1040	Profit or Loss from Farming	Gives income/loss and deduction details.
Schedule K-1	1065, 1120S	Partner's or Shareholder's Share of Income, Credits, Deductions, etc.	Self explanatory.
Schedule R	1040	Credit for the Elderly or the Disabled	A computation to reduce tax liability for qualified low-income taxpayers.
Schedule SE	1040	Self-Employment Tax	A computation for self-employed persons who complete Schedule C, F, or are qualified employees of religious organizations. Half of the tax is reported on the 1040 and treated as an adjustment to income to recognize the taxpayer is paying the employer and employee shares of FICA tax.
Schedule 1	1040A	Interest and Dividend Income for Form 1040A Filers	See Schedule B description.
Schedule 2	1040A	Child and Dependent Care Expenses for Form 1040A Filers	See Form 2441 description.
Schedule 3	1040A	Credit for the Elderly or the Disabled for Form 1040A Filers	See Schedule R description.

Guide to Implied Assets and Income

This chart is designed to assist financial aid administrators in using federal tax forms to verify the accuracy of information supplied on financial aid output documents. Note that, except for verification regulations, the collection of tax forms is optional. The chart suggests aspects of a family's cash flow and asset strength that may be indicated by federal tax documents. Implied income or assets should be verified by following up with aid applicants and their families. This chart is merely a guide to be used while assessing a family's financial data and while exercising professional judgment in individual cases.

Implied Assets & Income	Follow-up/Methodology
Additional Untaxed Income	See IRS Form 4562 and Form 1040, Schedule C, E, or F. Depreciation could be a paper loss rather than a real loss of income in many circumstances. It may be an indication of untaxed income to be reported on the FAFSA.
Savings Principal	See IRS Form 1040, 1040A, or 1040EZ; also, Form 1040, Schedule A or Form 1040, Schedule 1. Suggests a value should be reported on the FAFSA; interest earned divided by an appropriate interest rate equals implied principal. See IRS Form 1040, Schedule D. Cash received from sale of stock (whether a gain or a loss) may be available for other investment or savings reported on the FAFSA.
Investment Property Ownership	See IRS Form 1040 or Form 1040, Schedule E, or Form 4562. Suggests property ownership and indicates a value should be reported on the FAFSA.
Investment Principal	See IRS Form 1040 or 1040A or Form 1040, Schedule D. Suggests a value should be reported on the FAFSA.
Business Holdings and Assets	See IRS Form 1040 and Form 1040, Schedule C or C-EZ. Suggests assets and implies a value should be reported on the FAFSA.
Interest in Partnership, Estate, Trust or Chapter S Corporation	See IRS Form 1040, Schedule E. For partnerships or S Corporations, request Form 1065, Form 1120S, and/or Schedule K-1 of these forms. Suggests assets and may imply a value should be reported on the FAFSA.
Farm Holdings and Assets	See IRS Form 1040 and Form 1040, Schedule F. For federal purposes, do not include farm on which family resides; otherwise, suggests farm holdings and assets and implies a value may need to be reported on the FAFSA.[1]
Home Ownership or Property Ownership	See IRS Form 1040, Schedule A. If mortgage interest is reported, may suggest property ownership and indicate a value to be reported on the FAFSA.[1] For federal purposes, do not include principal place of residence.

[1]The FAFSA value reported for these items would not include the value of the principal place of residence or a farm if the farm is the family's principal place of residence and they claimed on Schedule F of the tax return that they "materially participate" in the farm's operation.

Appendix D

GUIDE TO ADDRESSING SPECIAL CIRCUMSTANCES

Introduction. This guide was developed by the NASFAA Need Analysis Standards Committee to assist aid administrators in complying with the provisions of Section 479A of the Higher Education Act ("professional judgment").

Beginning in 1993-94 financial aid administrator judgment extends to four areas previously included as part of the formal financial aid application, namely: private elementary and secondary school expenses, dislocated worker status, displaced homemaker status, and unusual medical and dental expenses. The Free Application for Federal Student Aid (FAFSA) directs applicants to contact the financial aid administrator if these or other unusual circumstances are present. Also, because of changes to the independent student definition, it may be necessary to collect additional information to determine whether a student who formerly met the definition has some special circumstance to warrant being treated as independent.

In addition to more typical professional judgment decisions, there may be other reasons to collect additional information. For example, the cost of attendance provisions of the statute (Section 472) require the inclusion of estimated actual expenses incurred for dependent care of a student's children based on the number and ages of dependents.

This guide identifies unusual circumstances affecting the parents of dependent students as well as independent students and/or spouses, and provides a description of the circumstances, suggestions for collecting and verifying data, and recommendations for implementing adjustments.

It is important to remember that the statutory authority for professional judgment decisions applies to *all* HEA Title IV programs (including Federal Pell Grants) and permits adjustments only on a case-by-case basis to *data items* in the cost of attendance and need analysis (i.e., determination of expected family contribution). Methodological changes and adjustments made directly to the EFC are *not* permitted. The financing method used by a family to pay an unusual expense, whether from current income or from asset reserves, will likely determine which data element is adjusted. Most of these circumstances may result in changes to one of two data items: (a) adjusted gross income, or (b) net assets.

The NASFAA Need Analysis Standards Committee welcomes your comments on this guide.

UNUSUAL MEDICAL AND DENTAL EXPENSES

Reason. Can be a hardship affecting a family's ability to pay. (Cited in the Higher Education Amendments of 1992 conference report as an item to be addressed on a case-by-case basis.)

Information gathering. For parents of dependent students and independent students (and spouses):

Table 1. Unusual medical and dental expenses
1. How much did you pay for medical/dental insurance in the base year? (Do not include employer's contribution.) $_____
2. What were your base year medical/dental expenses not paid by insurance? $_____
3. Will your unreimbursed medical/dental expenses will be lower, the same, or higher in the estimated year? Explain the reason.
4. From what sources will you finance these expenses?

Data verification. Income tax return (itemized medical and dental deductions); receipts of medical and dental payments.

Possible Implementation.

(1) Reduce adjusted gross income (AGI) by medical and dental expenses that exceed a certain percentage of total income (e.g., current IRS treatment or former Congressional Methodology or Pell Grant methodology treatment); or

(2) Reduce AGI by annual installment payments made for long-range medical and dental care (e.g., cancer therapy or orthodontic work); or

(3) Consider such long-range indebtedness as allowance against assets (may be a more accurate reflection of cash flow, since expenditures may be paid over a period of years); or

(4) Other.

SUPPORT OF EXTENDED FAMILY

Reason. To address on a case-by-case basis families who provide financial support to relatives who are unable to support themselves adequately but who do not qualify as family members.

Information gathering. For parents of dependent students and independent students (and spouses):

Table 2. Extended family support
1. Do you contribute financial support to a relative (or relatives) not counted as a member (or members) of your household? ___ Yes ___ No
2. If "Yes," provide the following information for each such relative:
Name of the supported relative
Age
Relationship to student
Support began (month, year)
Support ends (month, year)
Amount paid by you
Amount paid by other sources
Reason for support
3. Will these expenses will be lower, the same, or higher in the estimated year? Explain the reason.
4. From what sources will you finance this support?

Data verification. Receipts; billing statements.

Possible Implementation.

(1) Reduce AGI by amount of support; or

(2) Adjust family size; or

(3) Adjust assets; or

(4) Other.

ELEMENTARY AND SECONDARY SCHOOL COSTS;
CHILD CARE AND DEPENDENT CARE COSTS

Reason. Identifies added expenses related to attendance at tuition-charging schools, child care, or care of a disabled or elderly family member. (Elementary/Secondary School costs cited in the Higher Education Amendments of 1992 conference report as an item to be addressed on a case-by-case basis.)

Information gathering. For parents of dependent students and independent students (and spouses):

Table 3. Elementary and secondary education and dependent case expenses
1. Do you pay for elementary or secondary education expenses or dependent care expenses? ___ Yes ___ No
2. If "Yes," provide the following information for each family member receiving such support:
Name of supported family member
Age
Relationship to student
Child care expense
Elementary or secondary education expense
Adult dependent care expense
Total annual expense for base year
3. Will these expenses be lower, the same, or higher in the estimated year? Explain the reason.
4. From what sources will you finance these expenses?

Data verification. Income tax return (listing of dependents); receipts for tuition payments; signed, itemized statement of expenses.

Possible Implementation.

(1) Reduce AGI by expense amounts; or

(2) Add amount of dependent care expenses to student's cost of attendance; or

(3) Adjust assets; or

(4) Other.

UNUSUAL DEBTS

Reason. To address on a case-by-case basis families with high debt payments for unusual circumstances, such as mortgages or credit card debts to cover unemployment expenses or failed businesses; legal fees for divorce, adoption, etc.; education loans of parents or spouses; or personal debts for nondiscretionary expenses.

Information gathering. For parents of dependent students and independent students (and spouses):

Table 4. Unusual debts
1. Do you have unusual debts or loans for which you are *currently* making monthly payments? (Including mortgages or credit card debts to cover unemployment expenses or failed businesses; legal fees for divorce, adoption, etc.; education loans of student's parent(s)/spouse; or personal debts for nondiscretionary expenses.) ___ Yes ___ No
2. If yes, provide the following information:
Type or cause of debt
Owed by whom?
Amount of original debt; date incurred (month, year)
Balance owed on debt
Date payments began
Monthly payment
Holder of debt
Date payments end
3. Will these expenses be lower, the same, or higher in the estimated year? Explain the reason.
4. From what sources will you finance these expenses?

Data verification. Contract, mortgage, or lien; billing or payment summary from person, company, or agency to whom or which money is owed.

Possible Implementation.

(1) Reduce AGI by amount of annual installment payments on these debts; or

(2) Adjust assets, if this treatment may be a more accurate reflection of the family's cash flow; or

(3) Other.

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INCOME REDUCTION OR NONRECURRING INCOME

Reason. To address on a case-by-case basis instances when base year income does not accurately reflect a family's or student's ability to pay for education, such as divorce or death (possible displaced homemaker), change or loss of employment (possible dislocated worker), disability, or receipt of nonrecurring income.

Information gathering. For parents of dependent students and independent students (and spouses):

Table 5. Income reduction
1. Will your income and/or your parents'/spouse's income be less in the estimated year than in the base year for any of the reasons listed in question 2? ___ Yes ___ No
2. If "Yes," check the appropriate reason and explain, giving the date of the change in your situation.
___ (a) Unemployment or change in employment
___ (b) Divorce/separation
___ (c) Death of student's parent or spouse
___ (d) Disability of student or student's parent or spouse
___ (e) One-time income (e.g., inheritance, moving expense allowance, back-year social security payments, or IRA or pension distribution)
Date of occurrence: _____
3. If 2(e) is checked, identify the source of income, the amount, and how funds were spent or invested.
4. If 2(a), (b), (c), or (d) is checked, provide the following information for the period _____ (month, year) to _____ (month, year).
Wages, salaries, tips (including severance pay, disability payments, and any income from work
Other taxable income
Untaxed social security benefits
Aid to Families with Dependent Children (AFDC)
Child support received
Other untaxed income
TOTAL anticipated income
If you/your parent are/is divorced or separated, include only your/your custodial parent's income information. If the loss of income is due to the death of your spouse/parent, include only your/your surviving parent's income information.

Data verification. For estimated income: signed statements documenting estimated earnings; alimony or child support designated in divorce agreements; unemployment compensation and Job Training benefits; actual disability and social security benefits received. For nonrecurring income: income tax return (itemized deductions; moving expenses, capital gains and losses, etc.).

Possible Implementation.

(1) Use expected year income; consider using either anticipated calendar year income or academic year income; or

(2) If nonrecurring income was spent in the base year, reduce AGI by that amount; or

(3) If source of nonrecurring income is an IRA or pension distribution that has been rolled over, it should not be counted as income or as an asset because such retirement funds are not currently part of the Federal Methodology; or

(4) Other.

DEPENDENCY STATUS

Reason. To address on a case-by-case basis a student who claims to be independent but does not meet the federal criteria. The student must demonstrate self-sufficiency.

Information gathering. For students who may be considered to be independent of their parents:

Table 6. Dependency status
1. What is the amount of financial support you receive from your parents? $_____
2. What other support do you receive from your parents? (e.g., health insurance, room and board while living at home) Identify type of support and approximate value.
3. If your parents are unwilling to provide financial information to complete your FAFSA, explain the reason.
4. Indicate the amount and source of your annual income for the base year and estimated year (e.g., wages, monetary gifts from persons other than your parents, interest income).
5. Provide the following information about your expenses in the base year and estimated year. (if any amounts are zero, explain the reason.)
Housing
Food
Transportation (car payments, insurance, gas, maintenance)
Utilities
Child care and/or dependent care
Personal (clothing, entertainment)
Other
TOTAL

Data verification. Income tax return for student and parent; student budget sheet; third-party statements; rent receipts; lease agreements.

Possible Implementation.

(1) Evaluate information submitted to determine whether the student should be considered independent based on "other unusual circumstances" category included in statute; or

(2) Other.

Acknowledgements

This monograph is the fourth, revised edition of a NASFAA publication that first appeared in 1983. It is a part of NASFAA's continuing effort to assist financial aid administrators in fulfilling their professional responsibilities.

The 1978-79 NASFAA Committee on Need Analysis and Delivery recognized the need to compile and distill information about professional judgment in need analysis in a publication that would benefit both experienced and inexperienced aid professionals. Through the efforts of that committee and the later work of the 1982-83 Need Analysis Standards Committee (in particular, Larry Dietz and Edward Franziem) the first edition of this publication, *Special Report #5*, was issued in May 1983. Changes in standard need analysis practices for 1984-85 necessitated a revised and expanded edition, issued as *Special Report #10* in December 1984.

A revised and expanded edition of the *Special Report* was published by NASFAA in October 1987 as a monograph, *Professional Judgment in Need Analysis*, which was prepared by Joe Paul Case. It was occasioned by the 1986 reauthorization of the Higher Education Act and the Tax Reform Act of 1986.

The Higher Education Amendments of 1992 brought substantial revisions to the need analysis provisions that were first incorporated in statute in 1986. These changes have prompted this revised monograph.

The present revision was prepared by Joe Paul Case in cooperation with the members of the 1992-93 Need Analysis Standards Committee, who assisted by providing direction for this publication and in reviewing its content. The committee members were:

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It is the intent of the Need Analysis Standards Committee to update this publication whenever changes in need analysis procedures may warrant a new edition. The Committee encourages the membership of NASFAA and other interested individuals to comment on this monograph.

This publication contains material related to federal Title IV student aid programs. While NASFAA believes that the information contained herein is accurate and factual, this publication has not been reviewed or approved by the U.S. Dept. of Education. (This disclosure is required under Department Contract #PM92010003.)

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